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In the Supreme Court of the United States

OCTOBER TERM, 1925.

KANSAS CITY TERMINAL RAILWAY COMPANY, ET AL,

VS.

CENTRAL UNION TRUST COMPANY OF NEW YORK, ET AL.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

REPLY BRIEF OF KANSAS CITY TERMINAL RAILWAY COMPANY ET AL.

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As anticipated in our original brief, our opponents suggest no principle by which to determine the "fairness" of an offer to creditors. The substance of their argument is that the chancellor should have discretion to decide how much more "in value" the creditor is to get than the stockholder, with no guiding principle or standard.

In support of this theory, they rely upon expressions in three judicial opinions. (*North American Company*

v. *St. Louis & San Francisco Railway Company*, printed as an appendix to their brief; *Western Union Telegraph Company* v. *United States & Mexican Trust Company*, 221 Fed. 545, 549; *Phipps* v. *Chicago, Rock Island & Pacific Railway Company*, 284 Fed. 945, 948.) All of these opinions are by the judge from whose decree the appeal in the case at bar was taken. His remarks *arguendo* gain no added weight by their repetition. They are an expression of opinion by the court below, no more. It is true that in the Western Union case and in the Phipps case, Judge Sanborn was sitting in the Circuit Court of Appeals, but in neither case was a precise statement of principle necessary to the decision.

In the Western Union case no offer at all was made to creditors and the decree of the lower court was reversed because it did not permit an intervening creditor to attack the fairness of the plan on this account. There was no need for the court to define the limits of the doctrine and it did not undertake to do so. It was sufficient for disposing of the case to say, as the opinion did, that, if the stockholders were offered "benefits equal to or greater than" were the general creditors, the purchase was fraudulent in law.

In the Phipps case, the creditors were offered securities which had priority in all respects over the securities received by the stockholders. In such a case, a statement in the opinion that the creditors received interests "of much greater proportionate value" and "more beneficial proportionately" than the stockholders, is true but it does not purport to be comprehensive.

Counsel refer to *Lane* v. *Equitable Trust Company*, 262 Fed. 918, involving the Wabash re-organization plan, but in that case the creditor did not rely upon the doctrine of the Boyd case. His claim was that the trustees in the mortgage were not entitled to a deficiency judgment.

It is said that the term "fairness" is analogous to the term "fraud" (page 14) and, by inference, that what constitutes it, should be left to the "wisdom, knowledge and consciences" of judges. But the determination of what constitutes fraud has never been left to the "wisdom, knowledge and consciences" of judges. "What is fraud in a court of law, is fraud in a court of equity" (Smith on Fraud, Section 230, page 250), and the courts have never left it to juries or to individual chancellors to determine, in their discretion, what constitutes fraud. It is unnecessary to discuss so elementary a proposition in detail. It is sufficient to refer to a single opinion of this Court (*Southern Development Company* v. *Silva*, 125 U. S. 247) where Mr. Justice Lamar in affirming a decree dismissing a bill in equity for rescission on the ground of fraud lays down a set of principles which could more fairly be called a formula than could the principle which we have advocated in our original brief.

Another general term which is frequently used in the law, is "ordinary care." Yet the courts have not left its application to the discretion of juries and chancellors. On the contrary, definite principles as to what constitutes ordinary care were early adopted. Such rules as "the last clear chance," the "fellow

servant rule," "safe place to work," "stop, look and listen" and "*res ipsa loquitur*" are but illustrations.

The fact is, that "fraud," "ordinary care" and "fairness' are all general terms, and are useless unless definite principles are established by which the rights of parties may be determined with relative uniformity, rather than according to the varying standards of individual jurors and individual judges.

But, counsel say, and repeat throughout their brief, that we are endeavoring to establish a "formula" instead of a principle.

They have allowed this epithet to take the place of a real analysis of our contention.

Our contention is said to be that the general creditor must, in all cases, be given income bonds or preferred stock. Even if we had so contended, our contention would not merit the hated term "formula." It would merely be the statement of a definite principle for which excellent arguments could be advanced, and for which authority exists.

But we have not so contended. What we have asserted and do assert is, that the general creditor, wherever the stockholder is allowed to participate in the re-organization, must be given a participation which maintains his relative rank above the stockholder to the full amount of his claim. It matters not precisely how this is done. In the great majority of cases, it would undoubtedly be by the issuance of income bonds or preferred stock. In some cases, where the plan of re-organization is simple and the classes of secured creditors few, some form of second or third mortgage

bond might be used. In others, the creditors might possibly be given some form of common stock—provided the stockholder's participation was somehow inferior to such common stock. In some cases, the creditor might get first preferred stock; in other cases, second preferred stock; in some cases, first income bonds; and in other cases, second income bonds. A variety of participations might be given, provided the essential principle is maintained that the creditor must always rank ahead of the stockholder.

It is said that the creditor ought not to be interested in priority (page 26), and that the re-organization managers might render a preferred security of less value than a junior security, by giving it a very low rate of interest or dividend, or otherwise. We anticipated this contention in our original brief (pages 46 and 47). It is sufficient to say here, that the offer to the creditor must in all cases be made in good faith and that the return on his security, for which he has preference over the stockholder, must bear some relation to the prevailing rates for money at the time.

It is next said (pages 12, 13 and 31) that there may be not sufficient property value to support the issuance of preferred stock and income bonds, and that re-organizations might become impossible. The latter argument was made and met in the Boyd case. The former answers itself. If there is no value to support the securities to be issued to the creditors, then, *a fortiori* there is no value to support the issuance of securities to the stockholders. If there is any value whatever to support the stockholders' securities, then

there must necessarily be a value to support the creditors' securities. As this Court said in the Boyd case (l. c. 508), "If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event, it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever." In making their argument, counsel have not only overlooked the above considerations, but also the fact that preferred stock, as well as common stock, under the laws of many of the states, may be issued without par value, and that income bonds do not purport to represent any property value. If, however, there were any difficulty, there are various ways in which it could be readily met. A good illustration may be found in the plan of re-organization of the Metropolitan Street Railway Company and allied companies in Kansas City, prepared by Judge William C. Hook of the Eighth Circuit, who was in charge of the receivership. In the plan, he incorporated the following provision:

> "(d) So that no person having a just demand against any of the street railway companies or the 'Railway' shall be denied participation in the reorganization, the 'New Company' shall, from time to time, as occasion requires, issue 'Special Deferred Securities' for all claims, liquidated by agreement or established by decree in the pending cases, which are inferior in right to the old bonds, but superior to the stock, and for which provision is not otherwise made in this plan. These securi-

ties shall run for the life of the 'Franchise,' and bear 6% interest, cumulative, and payable only out of the net earnings of the company. In no case shall the amount exceed the sum or sums liquidated, and they shall be tenderable in discharge thereof at par. They shall not constitute a lien upon the physical property of the 'New Company,' but their status shall be, as against the owners of the stock, substantially similar to that of preferred stock. Inasmuch as equitable provision has been made herein for all funded obligations of the old companies, these securities shall not be available for deficiency judgments in foreclosure or balances after application of proceeds of sales under collateral trusts."

(District Court Western Division, Western District of Missouri, *Kansas City Railway & Light Co.* v. *Metropolitan Street Railway Co.*, in Equity No. 3720, Vol. II, printed record p. 1633, filed August 16, 1915.)

Counsel suggest difficulties in obtaining the approval of securities by the Interstate Commerce Commission under Section 20a of the Interstate Commerce Act as amended by the Transportation Act of 1920. But it is inconceivable that the commission would find the preference of creditors over stockholders not "compatible with the public interest."

It is also said that the principle may be unjust to the bondholder because in some cases he may have taken a part of his participation in stock (page 28). That is a matter which is in the bondholder's power. He need leave nothing for the creditor in the ordinary case, provided he makes no agreement with the stockholder. If by agreement with the stockholder he accepts less than is his right, he has presumably received

a consideration for his concession. If he agrees to accept stock for a part of his claim, he has made his own bed. Furthermore, it would always be practicable, by dividing the different classes of stock into ranks, to give the bondholder stock which would rank above that given the general creditor. It should also be observed that the creditor does not bear the same relation to the bondholder as does the stockholder to the creditor. The creditor is not the mortgagor and owes no obligation whatsoever to the bondholder. If the bondholder chooses to make an agreement with the stockholder, he does so with his eyes open to the consequences, and the creditor owes him no duty with reference to the corporate property. The stockholder, on the other hand, is under an obligation to the creditor analogous to a trust (*Railway Company* v. *Howard*, 7 Wall. 392, 411). He is the mortgagor, and, if he acquires an interest in any manner, it must be in subordination to the creditor's claim (228 U. S. l. c. 504).

The truth is, that the principle which we have advocated, results almost inevitably from the nature of the situation. A court of equity takes from the creditor that which ordinarily is rightfully his, and gives it to the debtor. In doing so, the court undertakes to give the creditor, as a substitute for the direct resort to the property, to which he would otherwise be entitled, something which will preserve his right, but deprive him of the power to enforce it arbitrarily. Logically, he ought to be put in substantially the same position in the new company relatively to the stockholder, as he occupied in the old company (deprived,

however, of the right to a cash satisfaction of his claim) or, in the language of the court in *Guaranty Trust Company* v. *Missouri Pacific Railway Company*, 238 Fed. l. c. 818—"the normal relation between the two, general creditor and stockholder," should be preserved. It is not impracticable nor even difficult to do so. The court judicially knows that most receiverships, and virtually all foreclosures are brought about, not by inability to meet the floated indebtedness, but by difficulties in meeting heavy loads of interest on bonded indebtedness, and that, while such receiverships ordinarily begin with a creditor's bill, the defendant enters its appearance, confesses the allegations of the bill, and foreclosure suits immediately follow. In other words, the creditor's bill is but an incident to the foreclosure. (See an excellent monograph by Mr. James Byrne, on the Foreclosure of Railroad Mortgages contained in "Some Legal Phases of Corporate Financing, Re-organization and Regulation," by Francis Lynde Stetson and others, pp. 77, 79.) The floating indebtedness is ordinarily small compared to the secured indebtedness. Much of it is bought up for cash by the reorganization managers and retired, as in the Boyd case, and the total amount of securities which would have to be issued on account of it would be relatively slight.

This principle has been followed in several of the largest railroad reorganizations in the country, as we pointed out in our original brief, and in others it could have been followed with comparatively slight modifications of the plan and without any serious detriment to the effectiveness of the plan.

Counsel refer triumphantly to the fact that, in the Boyd case, preferred stockholders of the old company received preferred stock in the new company (pages 18 and 48). They find, in this, evidence that the court in the Boyd case, did not mean that creditors should retain their priority in the new company. For, they say, how could the creditors have priority, if they received preferred stock, where the preferred stockholders also received preferred stock? This is plausible, but of no force. It would be very simple, as we have pointed out, to give the creditors a first preferred stock, and the preferred stockholders a second preferred stock, and this is, in all probability, precisely what Mr. Justice Lamar would have said, had the question been raised.

Counsel say at page 36 with reference to the Boyd case: "It is not derived from the rule that a mortgagor may not buy in at his own mortgage sale and cut off intervening rights, but is a separate and distinct equitable principle, an example of equity's power to make exceptions to legal rules in order to secure equity." This court said in the Boyd case (l. c. 504): "Being bound for the debts, the purchase of their property, by their new company, for their benefit, put the stockholders in the position of a mortgagor buying at his own sale." And again (l. c. 506): "As against creditors, it was a mere form. Though the Northern Pacific Railroad was divested of the legal title, the old stockholders were still owners of the same railroad encumbered by the same debts. The circumlocution did not better their title against Boyd as a

non-assenting creditor. They had changed the name, but not the relation. The property in the hands of the former owners under a new charter was as much subject to any existing liability, as that of a defendant who buys his own property at a tax sale." Further comment is unnecessary.

Counsel argue (pages 28 and 29) that, since the bondholders in reorganizations usually concede something to procure the adherence of the stockholders, what the stockholders get thereby should be deemed to have been obtained at the expense of the bondholders and not of the unsecured creditors, and they quote a sentence from Fletcher's Cyclopedia of Corporations to the effect that, in such a case, the secured creditors cannot complain. This quotation, however, as will be seen from the foot note in the Cyclopedia, is based upon the case of *Farmers Loan and Trust Company* v. *Louisville, etc., Railway Company,* 103 Fed. 110, decided by Circuit Judge Woods in the District of Indiana (see page 24 of our original brief) and afterwards disapproved by this court in the Boyd case (228 U. S. l. c. 503). The Monon case and the Boyd case make it clear that, if the bondholder chooses to depart from his right to a strict foreclosure by giving an interest in the property to the stockholder for the purpose of securing his consent to the foreclosure or of obtaining new money for the enterprise, neither the stockholder nor the new company can set up the alleged sacrifices of the bondholders in diminution of the rights of unsecured creditors. As this Court said in the Monon case:

> "It is one thing for a bondholder who has acquired absolute title by foreclosure to mortgaged property to thereafter give of his interest to others, and an entirely different thing whether such bondholder, to destroy the interest of all unsecured creditors, to secure a waiver of all objections on the part of the stockholder and consummate speedily the foreclosure, may proffer to him an interest in the property after the foreclosure" (174 U. S., l. c. 688).

To support their argument in favor of the unlimited discretion of the chancellor as against definite principles, counsel suggest at page 43 that differences in value of the property make a constant principle impracticable of application—notwithstanding the express statement in the Boyd case that "the invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property" (228 U. S. l. c. 507). They say, "In the Boyd case no contention apparently was made that the value of the property after providing for the mortgaged debt was insufficient to pay the mortgaged debt and accordingly, this Court did not decide that the creditor's right to go against the new company was independent of the value of the property." We leave counsel to explain how this statement can be reconciled with the following from the opinion in the Boyd case:

> "It is insisted, however, that not only the bid at public outcry, but the specific finding in the Paton case, established that the property was worth less than the encumbrances of $157,000,000, and hence that Boyd is no worse off than if

the sale had been made without the reorganization agreement" (228 U. S. l. c. 507).

The Guardian Trust Company case is next referred to, seemingly with the view of distinguishing or nullifying the Boyd case (page 43). It needs no argument to show that the Guardian Trust Company case is wholly consistent with the Boyd case. In the Guardian Trust Company case there was a reason for considering value which did not exist in the Boyd case—namely personal liability was decreed. But that it was unnecessary for the Court to ascertain the precise value of the property is evident from the last sentence of the second paragraph on page 176, where the Court says, "It appears to us that while perhaps *not justifying definite figures*, the reasoning warrants the belief that there was an equity for which the appellant must account" (240 U. S. l. c. 176) (Italics ours).

Both cases seem to recognize that the provision of stock for the old stockholders establishes that there is an equity. Both cases make it clear that, if there is an equity, the stockholders cannot participate, except in subordination to the creditors, and that the principle is not altered by variations in the exact value of the equity. "If their interest is valueless, he gets nothing. If it be valuable, he merely subjects that which the law had originally and continuously made liable for the payment of corporate liabilities" (228 U. S. l. c. 508).

Counsel seem to intimate on pages 39 to 42 of their brief that matters relative to preferential claims and receiver's certificates are largely controlled by the

discretion of the chancellor. Receiver's certificates need not be discussed, since they are issued by the courts as an administrative function rather than in the course of adjudicating controverted rights.

As to preferential claims, this Court, in *Kneeland* v. *American Loan & Trust Co.*, 136 U. S. 89, carefully pointed out that unsecured claims were entitled to priority only in a few "specified and limited cases" (l. c. 97), and warned counsel and the courts against the growing idea "that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of the displacement of vested liens" (l. c. 98).

The definiteness with which these priorities have been "specified and limited" is illustrated by the terse summary by Mr. James Byrne in his able monograph on Foreclosures of Railroad Mortgages (already referred to), at page 123, where he sums up in three simple rules the net result of the decisions of this Court and of the other federal courts on the subject.

In two or three places in their brief, opposing counsel assume that the Circuit Court of Appeals, in propounding the questions certified, intended to express its opinion that the offer to creditors in the case at bar was in fact fair. Of course, nothing of the sort was intended. That court attached the provisos to Question II and Question III so that all matters of fact should be eliminated from the questions, leaving for this Court's determination only propositions of law, in accordance with the statute and the rules of this Court.

Our opponent's brief, we repeat, lacks any suggestion of definite principle by which to determine how much more a creditor should get than a stockholder. They simply say that he should get as much or more. How much more is, presumably, to be left to the discretion of the chancellor. The rule which we have suggested not only furnishes a fixed and definite principle, but it is thoroughly consistent with the equitable principles out of which the Boyd case grew. It makes the doctrine of the Boyd case what it was intended to be, a relaxation of the equitable doctrine established by the Howard case and others and repeated by this Court in the Pierce case, that a corporation cannot transfer its assets to another corporation consisting of the same stockholders and thereby free its assets from the claim of creditors. To leave the whole question to the unlimited discretion of the chancellor is not to relax the doctrine, but to shatter it.

As this Court said in *Hollon Parker, Petitioner*, 131 U. S. 221, 225, "Rights under our system of law and procedure do not rest in the discretionary authority of any officer, judicial or otherwise."

Respectfully submitted,

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